

Message Text

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SUBJECT: OUTLINE FOR SUGGESTED REWRITE OF TWP PAPER ON
IMPACT OF HIGHER OIL PRICES ON OECD ECONOMIES

PASS COOPER (TWP DEL)

1. THERE FOLLOWS AN OUTLINE OF A SUGGESTED SUBSTITUTE FOR
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TWP PAPER ON "SOME ASPECTS OF THE ECONOMIC IMPACT..."
(DES/NI(75)8--1ST REVISION), AS REQUESTED BY COOPER, IN A
FORM WHICH MIGHT EVENTUALLY BE PASSED TO NON-OECD
COUNTRIES.

2. TITLE: ESTIMATING THE ECONOMIC EFFECTS OF AN INCREASE IN THE PRICE OF OIL ON OECD ECONOMIES.

ROMAN ONE: INTRODUCTION.

THE PROBLEM OF ISOLATING AND QUANTIFYING THE ECONOMIC EFFECTS OF AN INCREASE IN THE PRICE OF OIL IS A TASK OF IMMENSE DIMENSIONS. "INDIRECT" EFFECTS MAY BE GREATER THAN "DIRECT" EFFECTS, AND MANY RELATED EFFECTS NEED TO BE EXAMINED SIMULTANEOUSLY. AT THIS STAGE IT IS ONLY POSSIBLE TO OUTLINE THE BROAD CATEGORIES OF SIGNIFICANT EFFECTS; THOROUGH STUDY WOULD REQUIRE A BROADER AND DEEPER ANALYSIS THAN HAS BEEN DONE TO DATE. THIS STUDY SHOULD QUANTIFY THE EFFECTS AS FAR AS POSSIBLE.

3. THREE BROAD CATEGORIES OF THE MANNER IN WHICH THE WELFARE OF OIL IMPORTERS IS AFFECTED ARE CONSIDERED BELOW--

A) THE TRANSFER OF WEALTH; B) REDUCTION OF POTENTIAL OUTPUT; AND C) REDUCTION IN THE ABILITY TO ACHIEVE POTENTIAL OUTPUT. THE EFFECTS ON THE PRICE LEVEL ARE CONSIDERED SEPARATELY, ALTHOUGH IN FACT THIS DISTINCTION IS SOMEWHAT ARBITRARY.

4. ROMAN TWO. REDUCTION OF WELFARE.

A) TRANSFER OF WEALTH. THE MOST PROMINENT EFFECT OF THE INCREASE IN OIL PRICES INVOLVES THE MASSIVE TRANSFER OF PURCHASING POWER TO COUNTRIES WHICH ARE NET ENERGY PRODUCERS. THIS TRANSFER MAY TAKE THE FORM OF AN INCREASED VOLUME OF NET EXPORTS OF GOODS AND SERVICES BY CONSUMERS OR A TRANSFER (OR CREATION) OF FINANCIAL CLAIMS ON CONSUMERS. (THE BURDEN IS RELATIVELY MUCH MORE SERIOUS FOR LESS DEVELOPED COUNTRIES). SOME OF THE REAL TRANSFER HAS ALREADY OCCURRED, BUT A MAJOR PORTION IS STILL TO TAKE PLACE.

5. CONSEQUENTLY, THE RELATIVE SHARE OF WORLD INCOME OF OIL CONSUMERS IS REDUCED (I.E., A LOSS OF WELFARE) IN LIMITED OFFICIAL USE
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FAVOR OF OIL PRODUCERS. HOWEVER, A DETERMINATION OF THE "RIGHTNESS" OF THIS REVISED DISTRIBUTION OF INCOME IS NOT MADE IN THIS PAPER.

6. B) REDUCTION OF POTENTIAL OUTPUT.

THESE EFFECTS ARE THE MOST DIFFICULT TO DETERMINE BUT ARE PROBABLY THE MOST SIGNIFICANT. THEY WOULD APPEAR IN THE FOLLOWING FORMS:

7. A SHORT RUN ABSOLUTE REDUCTION IN POTENTIAL OUTPUT. INDUSTRIES UTILIZING LARGE AMOUNTS OF ENERGY IN PRODUCTION, OR PRODUCING PRODUCTS THE USE OF WHICH REQUIRES

LARGE AMOUNTS OF ENERGY, MUST REDUCE OR ELIMINATE UNPROFITABLE PRODUCTION. RESOURCES CANNOT BE IMMEDIATELY SHIFTED TO OTHER SECTORS.

8. SUBSTITUTION OF RELATIVELY HIGH COST ENERGY OR A MORE EXPENSIVE PROCESS USING LESS ENERGY. THERE IS A REALLOCATION OF RESOURCES TO LESS EFFICIENT USES SINCE LOW-COST ENERGY IS UNUTILIZED. CLEARLY THIS RESULTS IN A REDUCTION OF POTENTIAL OUTPUT ON A LONG-RUN BASIS.

9. A REDUCTION IN THE PRODUCTIVE CAPACITY OF EXISTING CAPITAL STOCK. EXISTING CAPITAL EQUIPMENT HAS BEEN DESIGNED FOR LOWER ENERGY PRICES, AND THE NEW LEVEL

OF PRICES IMPLIES A LOWER FLOW OF PRODUCTIVE SERVICES FROM THAT STOCK. SOME EQUIPMENT HAS TO BE SCRAPPED AND SOME REQUIRES PHYSICAL MODIFICATION. WHILE THIS REDUCTION IN PRODUCTIVITY OF CAPITAL STOCK IS TO A SUBSTANTIAL EXTENT TEMPORARY, THERE MAY BE SOME PERMANENT EFFECTS WHICH REDUCE POTENTIAL OUTPUT.

10. INDIRECTLY, A PERMANENT LOSS OF PRODUCTIVE CAPACITY TO THE EXTENT THAT THE CURRENT RECESSION, WITH ITS REDUCED INVESTMENT LEVELS, HAS BEEN CAUSED OR EXACERBATED BY THE INCREASE IN OIL PRICES (SEE BELOW).

11.C) REDUCTION IN THE ABILITY TO ACHIEVE POTENTIAL OUTPUT. THE OIL PRICE INCREASE HAS CAUSED ACTUAL OUTPUT IN THE OECD AREA IN THIS CYCLICAL PHASE TO DROP MORE SHARPLY
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BELOW POTENTIAL OUTPUT THAN OTHERWISE WOULD HAVE OCCURRED. DEMAND MANAGEMENT POLICIES HAVE IN MANY

CASES BEEN MORE RESTRICTIVE IN THE WAKE OF THE INCREASE IN OIL PRICES THAN THEY OTHERWISE WOULD HAVE BEEN. SOME WOULD ARGUE THAT THE "TAX" IN TERMS OF UNDERUTILIZATION OF RESOURCES IS SELF-IMPOSED. AT BEST, THAT ARGUMENT IS INCOMPLETE. OCCURRING AS IT DID AT THE END OF A PERIOD OF SYNCHRONIZED EXPANSION, THE SHARP JUMP IN OIL PRICES CREATED A CLIMATE OF PRICE EXPECTATIONS WHICH MADE POLITICALLY INFEASIBLE A FULLY COMPENSATING DEMAND MANAGEMENT POLICY. ALSO, THE SHARPLY INCREASED TRADE DEFICITS INDUCED MANY GOVERNMENTS TO ADJUST THEIR POLICIES SO AS TO REDUCE POTENTIAL FINANCING DIFFICULTIES. THESE CONSTRAINTS, WHICH HAVE BOTH ECONOMIC AND POLITICAL VALIDITY, WILL PERSIST OVER TIME, ALBEIT WITH A DECLINING INTENSITY.

12. ROMAN THREE. PRICES.
GIVEN THE ROLE OF PRICES IN MARKET ECONOMIES, THE EFFECTS

OF THE OIL PRICE INCREASE ON THE PRICE LEVEL IN ENERGY CONSUMING COUNTRIES CANNOT BE CONSIDERED IN ISOLATION FROM ITS EFFECTS ON POTENTIAL OUTPUT. NEVERTHELESS, IT IS POSSIBLE TO MAKE SOME OBSERVATIONS.

13. THE INDIRECT EFFECTS ON THE GENERAL PRICE LEVEL HAVE BEEN SUBSTANTIALLY LARGER THAN THE DIRECT EFFECTS. CERTAIN INDIRECT PRICE EFFECTS -- E.G., INCREASES IN PRICES OF OTHER ENERGY SOURCES AND PRICE INCREASES REFLECTING THE HIGHER COSTS OF ENERGY USED AS AN INTERMEDIATE PRODUCT -- CAN BE CALCULATED RELATIVELY EASILY. OTHER INDIRECT EFFECTS, PARTICULARLY THE WAGE-PRICE SEQUENCE RESULTING FROM WAGE-INDEXING AND ADMINISTERED

PRICING, OR THE EFFECTS OF THE OIL PRICE INCREASE ON GENERAL PRICE EXPECTATIONS, CANNOT BE NEATLY MEASURED.

14. A MAJOR UNCERTAINTY IS THE RATE AT WHICH THE INFLATIONARY FORCES SET IN MOTION BY THE OIL PRICE INCREASE WILL ABATE. EXPLICIT OR IMPLICIT INDEXING OF WAGES, TOGETHER WITH DOWNWARD WAGE RIGIDITY, GUARANTEES SOME FORM LIMITED OFFICIAL USE
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OF THE WAGE-PRICE SPIRAL, BUT THE EXTENT TO WHICH THIS PHENOMENON WILL BE DAMPED IS DIFFICULT TO PREDICT, PARTICULARLY IN VIEW OF THE UNCERTAINTY ABOUT FUTURE OIL PRICES. ROBINSON

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